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DIRECTORATE OF INTELLIGENCE

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China on the Eve of the Vice President's Visit

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Summary

Deng Xiaoping and other senior Chinese leaders are likely to be in an optimistic frame of mind for the Vice President's visit. Following a series of party meetings in mid-September, at which Deng appears to have gained most of his political objectives, China's leadership is younger, better-educated, and more committed to economic reform. More importantly, Deng has sharply limited the political influence of both the military and the conservative wing of the party, which have been opposed to his reform efforts. The party meetings also adopted guidelines for the 1986-90 Five Year Plan, which call for maintaining and expanding China's market-oriented economic policies. This despite a year of decidedly mixed economic performance. Administrative measures have begun to redress problems of too-rapid industrial growth, inflation, overextension of credit and uncontrolled consumer spending, problems which conservative critics have charged resulted from misguided or poorly implemented reform policies. Year-end statistics on agricultural production, industrial growth, the budget deficit, and China's foreign trade and foreign exchange

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performance are likely to be sobering. []

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Chinese leaders are generally satisfied with the overall state of US-China relations and should give the Vice President a cordial welcome. They will be interested in US-Soviet relations and prospects for the November summit, as well as arms control negotiations. In return, they probably will provide a readout on the latest round of Sino-Soviet talks. Deng and others will want to exchange views on regional issues of concern to China, particularly Korea, Indochina, and, of course, Taiwan. They will probably make another attempt to persuade the United States to support Deng's "one country, two systems" approach to reunification. Aside from Taiwan, bilateral trade issues--including protectionist measures pending in Congress, technology transfer, and energy cooperation--are likely to be on the agenda. Chinese leaders may also express their dissatisfaction with the decision to withhold family planning assistance funds. []

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Domestic Political Overview

Just weeks after the close of a landmark Central Committee meeting that fundamentally changed the composition of the party leadership, China's leaders are likely to be in an ebullient mood. After ten years of complex and time-consuming political struggle, Deng Xiaoping finally has established a leadership core that he believes can effectively lead China toward his goals of economic modernization and international prestige. He has severely weakened the party's "Old Guard"--veterans of the Long March and Civil War, conservative ideologues and dogmatic Marxist economic planners--and added significantly to the vitality and survivability of the "reformist" group he has led since Mao's death. []

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Deng's principal achievement at the mid-September party meetings was arranging the retirement of one-fourth of the Central Committee--including 10 of the 24 members of the Politburo--and replacing them with younger, better-educated leaders who share his vision of a modernized China. Most of the Politburo retirees, including Standing Committee member Ye Jianying, were aged veterans of China's revolution, respected symbols of a bygone era, and too old to carry heavy substantive or administrative burdens. Some--but not all--had been associated with conservative opposition to Deng's political and economic policies. Seven of the ten Politburo retirees were career military men, and their relinquishment of their positions of influence essentially caps Deng's ten-year drive to "demilitarize" the Politburo and depoliticize the military. Army representation on the Politburo and Central Committee is now at its lowest level since the early days of the Chinese revolution. []

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Six new members were added to the Politburo and four to the Secretariat at the Central Committee session that concluded the meetings. Most of them have demonstrated reformist credentials and have been groomed for higher positions for several years. Although we do not know the precise political alignments on the

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Politburo, it appears that strongly pro-reform leaders have gone from a distinct minority to a slim majority. The most important promotions to the Politburo are Hu Qili (rumored in line to replace Hu Yaobang as General Secretary), Li Peng (who may eventually replace Zhao Ziyang as Premier), and Foreign Minister Wu Xueqian. []

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Deng's gains in recasting the political shape of the Politburo were not won without cost, however. In a manner that has become characteristic of his political style, Deng traded policy for power, backpedaling somewhat in his support for some of the more controversial, free-market aspects of economic reform in exchange for his personnel choices. Deng's speech to the party conference of delegates was strongly ideological in tone, exhorting young leaders to study more classical Marxist theory and to avoid becoming entrapped in "bourgeois ideology." Obviously stung by both domestic and foreign depictions of China's economic reforms as "capitalist," Deng sharply refuted the charges, and insisted that the course he has laid out not only has brought prosperity, but is also ideologically correct: "Socialism with Chinese characteristics," leading directly to the goal of Communism. []

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Deng's conservative sentiments were more than matched by aged economic czar Chen Yun, by most accounts now Deng's principal rival on the Politburo. Chen's speech to the assembled delegates was bluntly critical of several of the problems that have accompanied new reform policies, and suggests that the controversy over the goals, pace, and philosophy of China's modernization will continue under the new leadership. In marked contrast to an address by Premier Zhao Ziyang, which lauded the success of reforms, Chen stressed China's continuing economic problems, and insisted that tight central planning, a cautious approach to economic experimentation, and other traditional socialist administrative methods were best suited to China's development. He also reiterated his skepticism about the wisdom of China's "opening to the West." In our judgment, Chen and other conservative elders remaining on the Politburo will continue to raise warnings and generally seek to slow the pace and scope of reforms. []

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China's Economy in 1985 -- Uncertain Progress

Economic statistics released by the government before the party meetings accentuated positive developments in China's economy, but much of the economic news this year has provided ammunition to conservative critics of reformist policies. In agriculture, for years the showcase of reformist success, a combination of bad weather and administrative problems in implementing new policies may bring about a drop in grain production, breaking a string of five consecutive bumper harvests. Overextension of rural credit early this year--in part a response to reformist plans to develop rural industry--has left some localities short of money to purchase the fall harvest, according to provincial press reports. Rural free markets have not developed as rapidly as regime planners had hoped, and decontrolling prices of certain agricultural products has led to major price increases for urban consumers, which Beijing has had to offset by increasing wage subsidies. []

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Spurred by a nearly 50 percent increase in China's domestic money supply, and huge increases in capital construction outlays by local enterprises, industrial output

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grew at an annual rate of 23 percent for the first half of 1985. This figure has alarmed conservatives and reformists alike, as it far exceeds growth in energy and raw materials production, and has increased the already serious strain on China's transportation system. In response, the government severely tightened credit, raised interest rates, and sharply curtailed access to foreign exchange by local economic units. All commentators have agreed that economic growth needs to be slowed, but there appears to be continuing controversy about what the optimum rate should be. The guidelines for China's 1986-90 five-year plan, adopted at the September party meetings, recommend 7 percent growth in industry, but both Deng and Chen Yun admitted that this rate would probably be exceeded. [REDACTED]

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China's foreign trade picture is mixed this year. Xinhua reported exports were down 2 percent in the first half of 1985, while imports skyrocketed 60 percent above the corresponding period in 1984. We estimate China's 1985 trade account will be in deficit, possibly by as much as \$5 billion, compared with a \$3 billion surplus in 1984. This will surely add fuel to the controversy surrounding the sharp drawdown in foreign exchange reserves that occurred between mid-1984 and mid-1985, when we estimate reserves dropped from more than \$16 billion to about \$10 billion. Critics charged that inappropriate trade policies--such as the government decision to import \$2 billion worth of luxury consumer goods to soak up excess currency--and pure fiscal mismanagement at both central and local levels are responsible for the problems. Remedial measures undertaken by the government include a tightening of controls on foreign exchange, and a few project cancellations. [REDACTED]

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China's overall standard of living in both urban and rural areas has improved significantly under reform policies, but it has become clear that inflation is a serious and growing problem. Even understated government statistics (which put the inflation rate at 7 percent) reflect a doubling of the rate this year. Money supply growth and sharply higher prices for agricultural products in urban markets have caused much of the problem, but unauthorized wage increases paid to industrial workers last year (up about 21 percent), uncontrolled rural credit expansion and a surge in both consumer spending and capital construction are major contributing factors. [REDACTED]

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Finally, China's economic development has been clouded by a serious rise in corruption at all levels of society. Although the economic and foreign trade impact of this problem is impossible to measure, the political repercussions are already being felt. Conservative critics have charged that the loosening of controls on economic activities, the "inappropriate" publicity given to "getting rich," and unclear guidelines on what constitutes legitimate business activity--all associated with reform policies--have created conditions in which corruption can flourish. Government efforts to curb the problem, including an embarrassing public revelation of a massive auto import scandal on Hainan Island, have only begun to have an effect. [REDACTED]

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Despite the welter of economic problems, China remains committed to the economic reform guidelines approved by the Central Committee in late 1984. Chinese leaders have been at pains to reassure foreign visitors and investors that the "open door" policy of expanded trade and investment opportunities is still in effect, and that Western participation in China's economic development is still welcome. These policies

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are nonetheless highly controversial, and subject to modification as conservative economists and ideologues maintain their pressure on Deng's reform coalition. []

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Foreign Policy

We believe Chinese leaders will give the Vice President a warm welcome, hoping to build on the Li Xiannian visit to Washington to further solidify US-China relations. Publicly, they are likely to stress the importance they attach to "stable" bilateral ties--a theme that has been more evident in their recent public statements and reflects their keen interest in obtaining more US help for their modernization drive. []

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Indeed, the Chinese probably will emphasize their interest especially in furthering economic relations. In doing so, we expect them to raise a number of concerns in private about real and potential obstacles to such expansion. These include:

- Rising protectionist sentiment in the US Congress.
- Continued impediments to the transfer of US technology to China, especially COCOM restrictions and US red tape.
- Opposition in the Congress to the US-China nuclear accord.
- Continuing problems in the negotiations over the Bilateral Investment Treaty.
- Although not just an economic issue, the Chinese are likely to complain vehemently about the recent decision to withhold family planning assistance through the United Nations. []

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On the strategic level, the Chinese probably hope the Vice President will brief them on what the United States expects to achieve at the Reagan-Gorbachev summit and in the strategic arms talks over the next several months. They may brief the Vice President in return on the outcome of the latest round of Sino-Soviet talks, scheduled apparently to end in Beijing just about the time the Vice President arrives. The timing, in our view, is no coincidence. The Chinese have scheduled such visits back-to-back several times over the past few years to emphasize implicitly their "independence" and importance in the strategic triangle. []

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In private, we expect Deng Xiaoping to express support for US moves to counter the Soviets--as he did with the President last year--and to endorse US efforts to reduce tensions with Moscow. If asked, however, Deng probably would reiterate China's opposition to the development and deployment of space-based weapons system. The Chinese fear that US plans to proceed with SDI will provoke the Soviets to develop countermeasures that would nullify their own nuclear deterrent and leave China even further behind the two superpowers technologically. []

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[redacted]

The Chinese almost certainly will raise a number of other foreign policy issues: the Koreans, Indochina, and, of course, Taiwan. Although the Chinese claim not to be concerned about the improvement in Soviet-North Korean relations, they may well urge the United States once more to expand its contacts with P'yongyang in the hope of arresting this shift. They may not say so, but they probably hold the United States partly responsible for the North's turn to Moscow for arms because of Washington's refusal thus far to respond to P'yongyang's overtures. Hu Yaobang, who has specific responsibility in this area, will probably take the lead on the issue. [redacted]

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The Chinese probably will also want to review the situation in Southeast Asia. They may be especially anxious to know whether there has been any change in the US position toward Vietnam as a result of the MIA negotiations and the US endorsement of ASEAN's proposal for proximity talks. They may also want to urge the United States to provide more support for the Cambodian resistance groups, including the Democratic Kampuchea faction now that Pol Pot has "retired." [redacted]

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Finally, we expect Deng and other Chinese leaders to make another attempt to persuade the United States to be more forthcoming in supporting Deng's "one country, two systems" approach as a means of promoting reunification between Taiwan and the mainland. [redacted]

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[redacted]

To give the United States an extra nudge, the Chinese may raise the possibility of taking some action in response to what they claim is the increasing likelihood of instability on Taiwan after President Chiang dies. [redacted]

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At least one leader will probably make the obligatory appeal for the United States to cut arms sales to Taiwan faster. There also is a remote possibility that the Chinese--probably at a lower level than Deng--might raise leaks in the US press about US collaboration in the development of an "indigenous" lightweight fighter for Taiwan. [redacted]

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Bilateral Economic Issues

Chinese leaders are likely to raise a number of bilateral economic issues in discussions with the Vice President. They recognize full well that China's concerns are not a major factor in US trade policy, and that there are important limitations on the development of bilateral trade relations. Nonetheless, they can be expected to try to capitalize on what they perceive as their strategic and political importance to the United States to gain more favorable treatment in trade. We estimate that China will run a small--perhaps \$250 million--trade surplus with the United States this year. [redacted]

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Energy -- The Three Gorges Project. Several countries, including the United States, are organizing efforts to cooperate with China in the design and construction of a mammoth hydroelectric power project at Three Gorges (San Xia), on the Yangtze River. The Chinese have not yet decided whether to go through with the project--they

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may opt to build smaller, less expensive coal-fired plants--but energy officials are accepting preliminary technical support from the United States, Japan, France and West Germany. The Chinese want low-interest, long-term financing for San Xia, and if that can be arranged, more detailed US proposals for design and construction assistance. There are indications, however, that the Chinese are negotiating with Japan for concessionary financing that would exclude non-Japanese firms from participation in the project. []

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Technology Transfer. China continues to press the United States for advanced dual-use equipment and technology for priority projects requiring supercomputers, computer networking, satellites, and fiber optics. Beijing claims these items are needed for civilian uses, but military needs drive the acquisition of many of these technologies. Beijing has been lobbying the United States and other COCOM members to loosen restrictions on technology transfer to China, and frequently complains to US Government visitors that other countries are more willing to sell equipment and technology. []

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Chinese leaders at the highest levels are likely to raise this issue, as they have in the past, in discussions with the Vice President and his party. They tend to view it as an important barometer of the overall state of US-China relations. []

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Textile Trade. US textile import restrictions are a source of considerable friction in bilateral trade relations. China relies on textile and apparel exports for at least one-fourth of its foreign exchange earnings, and the United States is one of its largest markets. Already dissatisfied with existing limitations on US imports of Chinese textiles, high-level leaders can be expected to make strong representations about measures currently pending in Congress, such as the Jenkins Bill. It is likely that the Chinese will threaten retaliatory cutbacks in purchases of US goods to underscore their concerns on this issue. []

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Bilateral Investment Treaty. Four issues still block agreement on a treaty. China is willing to grant US firms "most-favored nation" legal and financial treatment (US firms receive the same treatment as other foreign firms), but not "national treatment" (US firms treated the same as Chinese domestic enterprises). China believes that national treatment would be difficult because of the administrative differences between socialist and Western firms. Less complex issues include how to compensate foreign firms in the event of Chinese expropriation of their property, how to convert Chinese currency into internationally traded currencies, and how to settle disputes. Beijing is under no time pressure to conclude an agreement, and probably will remain inflexible on these four issues. []

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